DEPARTMENT OF STATE REVENUE

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Letter of Findings: 06-0497
Financial Institutions Tax
For the Years 2002, 2003, 2004

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ISSUES

I. Financial Institutions Tax – Imposition.

Authority: IC § 6-5.5-1-2; IC § 6-5.5-2-1; IC § 6-5.5-1-12; IC § 6-5.5.-1-13; IC § 6-5.5-1-17; IC § 6-5.5-1-18; IC § 6-5.5-2-3; IC § 6-5.5-2-4; IC § 6-5.5-3-1; IC § 6-5.5-3-3; IC § 6-5.5-5-1; IC § 6-8.1-5-1; 45 IAC 17-5-3; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Meadwestvaco Corp. v. Illinois Dep't of Revenue, 553 U.S. 16, 128 S.Ct. 9498 (2008); Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 112 S.Ct. 2251 (1992); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982).

Taxpayer protests the imposition of additional Financial Institution Tax claiming it is not unitary with various affiliates before 2002 and during the audit years.

II. Tax Administration – Imposition of Negligence Penalty.

Authority: IC § 6-8.1-10-2.1, 45 IAC 15-11-2.

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is in the business of providing mortgage banking services to its customers and has multiple locations in Indiana. Taxpayer is a wholly owned subsidiary of a holding company ("Mortgage Holding Co.") located in Texas. Mortgage Holding Co. is 99.9 percent owned by a bank ("Bank") and 0.1 percent owned by the affiliated group's parent corporation ("Parent Holding Co.") both located in Tennessee. Bank is 100 percent owned by Parent Holding Co. Parent Holding Co. files consolidated federal income tax returns with members of the affiliated group. Taxpayer began filing Indiana FIT returns in 1995 when it started doing business in the State. Taxpayer filed its returns separately excluding Parent Holding Co. and other members of the affiliated group.

The Indiana Department of Revenue ("Department") conducted a Financial Institutions Tax ("FIT") audit of Taxpayer for the years 2002, 2003, and 2004. The Department's audit resulted in the assessment of additional FIT, penalty, and interest. Taxpayer protested the assessment and penalties. A hearing was held on the protest and this Letter of Findings ensues. Additional facts will be provided as necessary.

I. Financial Institutions Tax – Imposition.

DISCUSSION

The Department's proposed assessment is based on (1) denying net operating loss ("NOL") carry forwards from years prior to 2002 on the basis that for the prior years the Indiana FIT return should have included all members of the unitary group which would have then wiped out the reported NOLs for 2002 and 2003, both audited years; and (2) adding two affiliated entities into a combined Indiana FIT return for the audit years, 2002 through 2004, which eliminated the reported NOLs for 2004.

Taxpayer protests (1) that the carry-forward to 2002 and 2003 of the NOLs created between 1995 and 2000 should not have been denied, since, irrespective of current analysis, it was not unitary with its affiliates during the years the NOLs were created; and (2) it is not unitary with the two affiliated companies the Department included for the years 2002 through 2004, and therefore its reported NOLs for 2004 should not have been eliminated.

The Department notes that all tax assessments are prima facie evidence that the Department's claim for the tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Within Indiana, "There is imposed on each taxpayer a franchise tax measured by the taxpayer's apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana." IC § 6-5.5-2-1(a).

An FIT taxpayer includes bank holding companies, regulated financial institutions (banks), and any subsidiary directly or indirectly owned by a bank holding company or bank. IC § 6-5.5-1-17.

The FIT is imposed on both "nonresident taxpayers" and "resident taxpayers" transacting business within this state. IC § 6-5.5-1-12, 13. The statute defines a "nonresident taxpayer" as "a taxpayer that (1) is transacting business within Indiana as provided in IC § 6-5.5-3; and (2) has its commercial domicile outside Indiana." IC § 6-5.5-1-12. A taxpayer, not filing a combined return, determines its FIT liability based on the taxpayer's adjusted gross income "multiplied by the quotient of... the taxpayer's total receipts attributable to transacting business in Indiana, as determined under IC 6-5.5-4; divided by... the taxpayer's total receipts attributable to transacting business in all taxing jurisdictions as determined under IC 6-5.5-4." IC § 6-5.5-2-3. In contrast, a taxpayer filing a

combined return determines its FIT liability based on its apportioned income consisting of the taxpayer's "(1) the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group; multiplied by... the quotient of... all the receipts of the taxpayer members of the unitary group that are attributable to transacting business in Indiana; divided by... the receipts of all the members of the unitary group from transacting business in all taxing jurisdictions." IC § 6-5.5-2-4.

IC § 6-5.5-3-1 describes what constitutes "transacting business" in Indiana for FIT purposes:

> For the purposes of this article, a taxpayer is transacting business within Indiana in a taxable year only if the taxpayer:
> (1) maintains an office in Indiana;
> (2) has an employee, representative, or independent contractor conducting business in Indiana;
> (3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;
> (4) regularly solicits business from potential customers in Indiana;
> (5) regularly performs services outside Indiana that are consumed within Indiana;
> (6) regularly engages in transactions with customers in Indiana that involve intangible property, including loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;
> (7) owns or leases tangible personal or real property located in Indiana; or
> (8) regularly solicits and receives deposits from customers in Indiana.

The Taxpayer protests two main issues, the discussion of which follows:

A. Carryforward of NOLs from prior years into the 2002 and 2003 FIT returns.

Taxpayer carried forward NOLs it had reported between the years 1995 and 2000 to its separately filed 2002 and 2003 Indiana income tax returns. The Department's audit disallowed these NOLs stating that Taxpayer was unitary with its federal consolidated group during the years these NOLs were created and therefore was required to file combined Indiana income tax returns for those years which then eliminated the 2002 and 2003 NOLs, resulting in an assessment of FIT.

Taxpayer argues that it was not unitary during the years in which these NOLs originated. Taxpayer states that even if, arguably, it would be deemed unitary during the audit period, 2002 through 2004, Taxpayer was not unitary during the years prior to 2002 when the NOLs were created, because its corporate structure was vastly different then. Taxpayer thus argues that it correctly filed separate returns for 2002 and 2003 and properly reported losses due to the carry forward of these NOLs.

Prior to January 1, 2002, Indiana FIT law included all members of a unitary group on an FIT return if one member of the unitary group was conducting business in Indiana regardless of whether or not the other members of the unitary group were transacting business in Indiana. IC § 6-5.5-1-18. 45 IAC 17-5-3(d) clarified:

> If one member of the unitary group is conducting the business of a financial institution in Indiana, then all members of the unitary group engaged in a unitary business must file a combined return even if some of the members are not transacting business in Indiana.

IC § 6-5.5-5-1 stated that a unitary group of at least two taxpayers must file a combined return covering all operations of the unitary business. The combined return must include the adjusted gross income of all members of the unitary group, even if some members would not otherwise be subject to the FIT. IC § 6-5.5-1-2.

A unitary business is defined in IC § 6-5.5-1-18, as business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group. Unity is presumed whenever there is unity of ownership, operation, and use evidenced by centralize management, or executive force, centralized purchasing, advertising, accounting, or other controlled interaction among the entities.

The statutory definition of a "unitary business" is found at IC 6-5.5-1-18(a) and (b).

> "Unitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. The term may be applied within a single legal entity or between multiple entities and without regard to whether each entity is a corporation, a partnership, a limited liability company, or a trust, provided that each member is either a holding company, a regulated financial corporation, or a subsidiary of either, a corporation that conducts the business of a financial institution under IC 6-5.5-1-17(d)(2), or any other entity, regardless of its form, that conducts activities that would constitute the business of a financial institution under IC 6-5.5-1-17(d)(2) if the activities were conducted by a corporation. The term "unitary group" includes those entities that are engaged in a unitary business transacted wholly or partially within Indiana.
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> Unity is presumed whenever there is unity of ownership, operation, and use evidenced by centralized management or executive force, centralized purchasing, advertising, accounting, or other controlled interaction among entities that are members of the unitary group, as described in subsection (a). However, the absence of these centralized activities does not necessarily evidence a nonunitary business. See also 45 IAC 17-3-5(c).

The U.S. Supreme Court has considered the issue of a unitary relationship for adjusted gross income tax in several cases. The essential characteristic the Court requires for a unitary business is that the individual entities

are functionally integrated in a common business. Meadwestvaco Corp. v. Illinois Dep't of Revenue, 553 U.S. 16, 128 S.Ct. 9498 (2008); Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 112 S.Ct. 2251 (1992); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982). The Supreme Court found that unitary businesses that were functionally integrated shared many common characteristics. They had common ownership ("unity of ownership"). They had centralized management with a corporate strategy including the various entities ("unity of use"). Lastly, the individual businesses were operated in such a manner as to further a common purpose (for example, accounting, payroll, pension, advertising, etc.) ("unity of operation").

The Department's audit is correct that prior to January 1, 2002, the other members of Taxpayer's consolidated group need not have been doing business in Indiana in order to be combined on an Indiana FIT return. The only requirement would have been that Taxpayer, the entity doing business in Indiana, was unitary with the affiliates the Department's audit included in the combined return.

The Department's audit correctly recites the relevant statutes and regulations. However, the Department's audit proceeds from a statement of the law directly to the conclusion that Taxpayer is unitary with its federal consolidated group for the years prior to 2002 without even a minimal exposition of facts or analysis that explain that conclusion.

This Letter of Findings does not take a position as to whether or not Taxpayer was unitary with its federal consolidated group in the years prior to 2002 – it may very well have been – however, the Department's audit report does not present a rationale to support this conclusion.

Taxpayer's protest of the 2002 and 2003 assessments resulting from the removal of NOLs carried forward to 2002 and 2003 by combining Taxpayer with its federal consolidated group is sustained.

B. Inclusion of "Bank" and "Processing" in combined return with Taxpayer during audit years.

The Department's review of Parent Holding Co.'s consolidated federal income tax returns for the periods 1995 through 2004 revealed that Taxpayer had members of the affiliated group registered for withholding tax in Indiana. During the audit period of January 1, 2002, through December 31, 2004, Bank and another affiliated check processing company ("Processing") reported withholding tax in Indiana. This implied that Bank and Processing had employees in the state and were, therefore, doing business in Indiana. Neither Bank nor Processing had previously filed Indiana returns.

The Department's audit combined Taxpayer, Bank, and Processing as unitary entities doing business in Indiana on single Indiana income tax returns for the audit years which resulted in an elimination of NOLs Taxpayer had carried forward to its separately filed 2004 return.

Taxpayer argues that on average it had de minimis payroll in Indiana for those entities and therefore were not "doing business" in Indiana.

Effective January 1, 2002, IC § 6-5.5-1-18 was modified to define "unitary business" to exclude entities that were not doing business in Indiana:

> (a) "Unitary business" means business activities or operations that are of mutual benefit, dependent upon, or contributory to one another, individually or as a group, in transacting the business of a financial institution. The term may be applied within a single legal entity or between multiple entities and without regard to whether each entity is a corporation, a partnership, a limited liability company, or a trust, provided that each member is either a holding company, a regulated financial corporation, a subsidiary of either, a corporation that conducts the business of a financial institution under IC 6-5.5-1-17(d)(2), or any other entity, regardless of its form, that conducts activities that would constitute the business of a financial institution under IC 6-5.5-1-17(d)(2) if the activities were conducted by a corporation. The term "unitary group" includes those entities that are engaged in a unitary business transacted wholly or partially within Indiana. However, the term does not include an entity that does not transact business in Indiana.
>
> (Emphasis added).

If two or more entities are found to be unitary and doing the business of a financial institution in Indiana, IC § 6-5.5-5-1(a) states:

> Except as provided in this section, a unitary group consisting of at least two (2) taxpayers shall file a combined return covering all the operations of the unitary business and including all of the members of the unitary business. However, only one (1) combined return needs to be filed, as provided in IC 6-5.5-6-1.

IC § 6-5.5-3-1 describes "transacting business within state:"

> For the purposes of this article, a taxpayer is transacting business within Indiana in a taxable year only if the taxpayer:
>
> (1) maintains an office in Indiana;
>
> (2) has an employee, representative, or independent contractor conducting business in Indiana;
>
> (3) regularly sells products or services of any kind or nature to customers in Indiana that receive the product or service in Indiana;
>
> (4) regularly solicits business from potential customers in Indiana;
>
> (5) regularly performs services outside Indiana that are consumed within Indiana;
>
> (6) regularly engages in transactions with customers in Indiana that involve intangible property, including

loans, but not property described in section 8(5) of this chapter, and result in receipts flowing to the taxpayer from within Indiana;

(7) owns or leases tangible personal or real property located in Indiana; or

(8) regularly solicits and receives deposits from customers in Indiana.

(Emphasis added).

IC § 6-5.5-3-3 elaborates on what IC § 6-5.5-3-1(2) "conducting business" means:

An employee, representative, or independent contractor is considered to be conducting business in Indiana if:

(1) the employee, representative, or independent contractor is regularly engaged in the business of the taxpayer in Indiana;

(2) the office from which the employee's, representative's, or independent contractor's activities are directed or controlled is located in Indiana and a majority of the employee's, representative's, or independent contractor's service is not performed in any other taxing jurisdiction; or

(3) a contribution to the Indiana employment security fund is required under IC 22-4-2 with respect to compensation paid to the employee.

Taxpayer's argument that Bank and Processing had de minimis presence in Indiana is mistaken. IC § 6-5.5-3-1(2) clearly applies even if the entities had a single – " an" - employee conducting business in Indiana. Taxpayer has not refuted that fact. Taxpayer has made no other arguments to support its protest that Bank and Processing are not doing business in Indiana. The Department's auditor requested more information from Taxpayer about the nature of Bank's and Processing's business in Indiana, but the Taxpayer was not forthcoming with information. The audit, therefore, found that Bank and Processing were doing the business of a financial institution in Indiana based on the best information available to it. Taxpayer has not overcome the presumption of correctness. IC § 6-8.1-5-1(c).

The audit's determination that Bank and Processing are doing business in Indiana and are therefore subject to Indiana's FIT stands. However, since the Department's audit did not state a case for the unitary relationship between Taxpayer and these two entities (see above section), Bank and Processing cannot be included in a combined return with Taxpayer for the years at issue. This Letter of Findings takes no position on whether or not Taxpayer is actually unitary with Bank and Processing.

FINDING

Taxpayer is sustained on its protest of the Department's determination that it was unitary with its federal consolidated group for the years prior to 2002.

Taxpayer is sustained on its protest of the Department's determination that it was unitary with Bank and Processing during the audit years.

Taxpayer's protest that Bank and Processing are not subject to FIT is denied. Bank and Processing are subject to Indiana FIT.

II. Tax Administration – Imposition of Negligence Penalty.

DISCUSSION

The Taxpayer also protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has provided sufficient documentation to show that it was not negligent.

FINDING

Taxpayer's protest of the assessment of the negligence penalty is sustained.

SUMMARY

Taxpayer is sustained on its protest of the Department's determination that it was unitary with its federal consolidated group for the years prior to 2002.

Taxpayer is sustained on its protest of the Department's determination that it was unitary with Bank and Processing during the audit years.

Taxpayer's protest that Bank and Processing are not subject to FIT is denied. Bank and Processing have an Indiana FIT filing requirement.

Taxpayer's protest of the assessment of the negligence penalty is sustained.

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